THE RAILROADS AND THE INVESTOR

THOMAS REED POWELL
Associate Professor of Constitutional Law, Columbia University

THE lesson for the day is "The Railroads and the Investor." As money makes the mare go, so it does the railroads. Money from freights and fares will run the roads after they are built. But the roads must be built before they can be run. Expenditures for initial construction and capital outlays for extensions cannot be squeezed from shippers and passengers. They must be obtained from investors or from the government. There are but two ways of securing the necessary capital for the railroads. One is coercion; the other is seduction. If the government chooses to finance the roads, it may use both coercion and seduction. It can tax and it can borrow. If, on the other hand, we are to finance the roads through private investment, our only recourse is to the arts of seduction. We must persuade those who have money that it is worth their while to become stockholders or creditors of the corporations which own the roads. Whether persons with money will care to put it to the use of the railroads will depend upon what they can look for by way of interest or dividends as compared with what they can hope to get if they put their money elsewhere.

The gentlemen who are to address us this afternoon are to tell us what seductions we must practice on investors to prevail upon them to put their money into railroad stocks and bonds. This may not be the precise point to which their remarks are directly addressed; but it is a point on which all their remarks must bear. For the treatment accorded to those who have already put their money into railroads has an important relation to the seduction of those whose further aid the road must have. If past investors are dissatisfied, future investors will insist on inducements more alluring.

The interests of past investors are supposed to be protected by the courts. Legislatures and commissions may limit the returns of investors by limiting fares and freights. But there is a limit to this limitation. The courts require that the fares and freights be left high enough so that the roads earn what is called a fair return on their fair value. Perhaps we may learn this afternoon

what this so-called "fair value" is; but up to the present moment, nobody knows. It can't be what the roads would be worth if their rates were not subject to regulation, for this would defeat the undeniable power to regulate. It isn't what the roads actually cost, and it isn't exactly what it would cost to build them now in their present partly worn-out condition, though it squints a good deal in this latter direction. The courts have been more explicit in telling what fair value is not, than in saying what it is. Whatever it is, it is some combination of incongruities, some compromise of competing inconsistencies.

The judicial treatment of the problem has been woefully artificial. With an animism which reminds us of the days of the deodand, the courts have talked as though what was being regulated was the roads themselves, the physical equipment of ties and track and rolling stock. Plainly a realistic approach to the problem would have recognized that regulation affects persons, not things. The parties in interest are the shippers and passengers on the one hand, and the stockholders and bondholders on the other. Plainly, too, the situations of the stockholders and bondholders are not the same. The bondholders have contracted for an agreed rate of return. The stockholders have taken a chance. Yet the return to which the court refers is a return to the road, not to the persons interested in the road. The road must have a fair return on *its* fair value. The bondholders then get the return they have contracted for; the stockholders get the rest. Thus where a road is financed largely by bonds bearing interest at a lower rate than that allowed to the road as a fair return on its fair value, the rate of return for the road gives but an imperfect index of the rate of return enjoyed on the stockholder's investment. Yet it is that investment which is affected by rate regulation and which ought to be the primary object of judicial attention as it is necessarily the primary object of judicial concern.

The courts have been much more certain about what is a fair return than about what is fair value. Until very recently they have regarded six per cent as a fair return and have sometimes approved of less. They seem to have been guided by the normal rate of interest on money loaned rather than the normal rate of income from business. Yet, from the stockholder's standpoint, the railroad enterprise is a business, subject to the fluctuations which other businesses must face. Investors would not put

money into railroad stock with no hope of getting more than six per cent and no guarantee of getting that, when they could put it into other businesses where the risk is no greater and the returns are not subject to legal limitation.

Undoubtedly some of the artificialities of which the courts have been guilty tend to counterbalance each other. This is true of the failure to note the relevance of the ratio between bonds and stock and the fixing of the rate of fair return at the normal interest rate on money loaned. Six per cent on the fair value of the road may mean more than six per cent for the stockholders and so tend to put their investment on a par with those in other businesses. So also the rather rigid limitation on the rate of return may be offset by the liberality displayed in the judicial guessing as to fair value. And results which might seem to be a formal injustice to stockholders may be formal only and not substantial, by reason of the circumstances under which the stock was acquired.

Another element to be considered is that rate regulation must often fail to depress the rates to the lowest point that would pass muster with the courts. Governmental regulation of railroads rides two horses that often go in different directions. We wish rates to be reasonable; we desire them also to be proportional. So long as our test of reasonable is based largely on the financial results to the roads, it must follow that a schedule of rates which would be reasonable for one road would be too high or two low for others. If we should reduce the rates on the favorably-situated roads to the lowest point which will yield them a fair return on their fair value, their less favorably situated competitors could not do business unless their rates were equally low. And by hypothesis this would leave them less than a fair return. That such indirect results of lawful regulation of the stronger roads would never be regarded as an unconstitutional taking of the property of the weaker roads must be practically certain. Nevertheless it is a misfortune which we have not thus far sought to put upon the weaker roads. We have dealt with groups of carriers rather than with individual roads. Thus it must happen that the stronger roads have not been restricted to the lowest rates that the courts would sanction. This is nice for the stockholders, but not so nice for shippers and passengers. Here is a problem still awaiting a satisfactory solution.

Enough has been said to indicate how far our existing methods of control fail to deal realistically with the competing interests of the carriers and their patrons. What the results have actually been or what they are likely to be cannot be known by one whose reading had been largely confined to judicial opinions. By and large the courts seem to have tried to protect railroad property in such enhancements of value as are enjoyed by property devoted to other uses. As it is the monopoly position of the roads which gives rise to governmental limitation of their charges, so the primary purpose of rate regulation would seem to be the prevention of exactions that are rendered possible only by such monopoly position. If we mean to go further and prevent the enhancement which other property is still allowed to enjoy, we can hardly expect persons to put their money into regulated enterprises, so long as unregulated enterprises compete for it. If we plan to deny the prospect of any unearned increment, we must certainly offer security against decrement. If we are to seduce investors to put their money into railroads, we must meet the seductions offered by other businesses. The courts seem to have had this necessity vaguely in mind, and to have intended to thwart the rate regulation that would deter investors. If their handling of the problem has been unsatisfactory, it is due in considerable part to the way in which the task has been put upon them. Our legislatures and commissions have dodged the genuine issues in the situation and have felt their way timidly and compelled the courts to grope in darkness.

The topic of this afternoon recognizes that the genuine issue is one of returns to investors so long as the roads continue to be financed by private investment. The approach to the railroad problem from the investor's angle is essential, whether we continue existing methods of governmental control or devise new ones. An understanding of the investor's position is a necessary prerequisite to a decision whether we shall continue existing methods or devise new ones, and, if the latter, to the choice between the various expedients open to us. If we are to stick to some form of seduction of investors, we must know how much seduction is necessary to get the desired results. If investors prove too coy, we shall know that we must try coercion. Coercion means in the long run the raising of funds by taxation or else the very exaction on shippers that regulation seeks to prevent. Coercion leads to governmental guarantees if not to government

ownership. Thus the problem of the investor and the problem of the public touch each other. The public must satisfy the investor if it wishes him to continue to invest. The investor must not demand too much of the public if he wishes the opportunity to invest. Thus the papers of this afternoon's session, though concerned with the railroad problem primarily from the standpoint of the present owners of railway securities, necessarily will throw light on the larger public issues which existing conditions force on our attention.